In the matter of terms and conditions to be prescribed by the Commission in connection with the issuance of securities under Section 20*a* of the Interstate Commerce Act, as amended.

The Marketing of American Railroad Securities

MEMORANDUM FOR THE
INTERSTATE COMMERCE COMMISSION

submitted by

KUHN, LOEB & COMPANY

William and Pine Streets
New York

KUHN, LOEB & CO.

Nov. 27, 1922.

Dear Sir:-

Believing that the subject matter may possibly be of interest to you, we beg to enclose herewith copy of a memorandum which we have submitted to the Interstate Commerce Commission in connection with the recent hearing before that body "in the matter of terms and conditions to be prescribed by the Commission in connection with the issuance of securities under section 20-a of the Interstate Commerce Act, as amended".

Respectfully yours,

KUHN, LOEB & CO.

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INTRODUCTION

The Problem

NO more important problem today challenges the skill and wisdom of American railroad managements—and the public authorities charged with the function of regulation—than that of how to obtain the capital necessary to provide the facilities required to transport the commerce of our growing country.

Railroad Requirements for Capital Aggregate Huge Sum Yearly

It has been estimated by several high authorities that in order to meet with any degree of adequacy the requirements for new construction, for additional main tracks, sidings, and yards, for equipment and terminal facilities, for elimination of grade crossings, especially in the larger cities, for block signaling and other safety appliances, and the requisite general strengthening and improvement of existing properties, expenditures are called for, aggregating as much as $1,000,000,000 a year for a series of years to come.

There is a never-ceasing demand in the United States for more and better railway services. Unless this demand is to remain unsatisfied the railway managements must find some way to attract to the railway industry an uninterrupted and steadily augmenting flow of new capital.

The problem is no less vital to the public whose prosperity and convenience so largely depend upon the adequacy of its transportation service. At the same time,

the public which pays the rates providing the return earned upon capital invested in railroads, has a clear interest in having the railroads sell their securities—and obtain their new capital—upon terms which involve no burden upon rates beyond that actually necessary to attract the required capital.

New Railway Capital Must Be Attracted From the Savings of the People

Capital already invested in railroad facilities is irrevocably committed, but any and all *new* capital *must be attracted* from the investing public upon terms and under conditions which appeal to that public.

It is thus of essential importance that the following purposes be accomplished:

1. Obtain the capital.
2. Attract it upon fair and reasonable terms.
3. Have a broad and stable market for railroad securities and a favorable disposition on the part of investors toward such securities.

Generally speaking, the *existing method* of disposing of railroad securities is by three processes:

Existing Method of Disposing of Railway Securities

1. Offering stocks pro rata to existing shareholders, the issue usually being underwritten by bankers;
2. Selling bonds at a fixed price to bankers, who through the medium of a syndicate and with the cooperation of distributing houses throughout the country, market them to the public; and
3. Selling an issue through a banker to the public, with a commission to the banker for his services. (This method is very rarely employed.)

Now Proposed To Sell Securities by "Competitive Bidding"

The question is now raised whether it would be well that the existing practice be changed and that railroad securities hereafter be sold by one of the following methods, viz:

1. Unrestricted public bidding; or
2. Competition among bankers.

Such a change would of course involve the abandonment of the heretofore prevailing method, under which a railroad company usually selects a banking house of high standing, and, so long as the services of that banker are satisfactory, makes its issues of securities customarily through or with the aid of that house.

The suggested change contemplates that the relationship between the railroad and the investment market shall be similar to that between American municipalities and the investment market, wherein issues of securities are usually sold by competitive bidding.

In considering this problem, the paramount question is: How can it be made certain that the vast amounts of new capital required by the railroads, year in and year out, shall be forthcoming upon the most advantageous terms?

I

The Existing Practice of Dealing Through Bankers

A. With American Railroads

As a rule, railroad companies of the United States, like those of other countries, market their bonds by selling them either to or through bankers. In cases where securities are offered for *pro rata* subscription to stockholders it is customary for the corporation to protect itself by arranging with bankers to underwrite, or to form a group to underwrite, their sale, that is, to agree to purchase such of the securities as are not taken by the stockholders.

Most of the important railroad companies, as well as industrial corporations, make a practice of dealing with a particular banking house or a particular group of bankers in marketing securities. This relationship rarely rests on formal contract. As a rule, the relationship is informal and tacit and its duration, as will be developed in detail further on, depends wholly upon the satisfaction of the railroad with the services rendered. A railroad company gradually comes to recognize a particular banking house as its banker.

The Banker's Service Available to the Railroad Continually

The existence of such a relationship means that the railroad has at its disposal continuously the services, skill, standing, experience, advice and financial influence and capacity of the banker.

Among the banker's functions are to keep track of

the financial situation and requirements of the railroad, to assist in the preparation, in advance of the need, of a proper and serviceable system for financing such requirements; to advise as to the class, kind and denomination of securities to be issued and as to the best time for selling them, so that his clients may not miss an opportune moment for meeting their requirements; to indicate from his survey of the markets of the world his judgment as to the amount of securities which could be absorbed in one or the other market; to scrutinize the mortgages and deeds of trust under which securities are to be issued, with a view to their provisions being, on the one hand, carefully protective of the investor, and, on the other hand, sufficiently broad and elastic not to hamper and restrict the corporation unduly in respect of its future requirements.

Affiliation With Bankers Depends Entirely on Satisfactory Service

The terms of a negotiation are by no means imposed by the banker, for it is easily within the means, and is recognized as an important and responsible duty, of those conducting negotiations on behalf of the railroad company, to acquaint themselves with the reasonable market value of the securities which it desires to sell and to insist upon obtaining a fully adequate price.

The railroads for whom bankers act nowadays can have no inducement to continue that affiliation except satisfaction with the services rendered.

Railroads Free to Change Their Bankers

A railroad company generally is, and always ought to be, free to terminate its relationship with its bankers at any time and entirely within its own discretion.

That changes in the relationships between railroads and bankers do occur is indicated by the variations which take place in the course of time, in the connections, and

the relative influence and position of the prominent banking firms which deal in railroad securities.

The relationship between the railroad and its bankers is one which, whilst not limiting the railroad's freedom of action according to its own judgment of its best interest, does involve upon the part of the bankers certain definite and continuous duties and obligations, more fully referred to later on.

B. With Industrial Corporations

Industrial corporations, unlike railway companies subject to public regulation, are entirely free to sell their securities in whatever way they deem most advantageous. Their managers, or presidents, are very frequently among the larger stockholders, and indeed, in numerous cases, are the principal stockholders, of the respective concerns, and therefore have a more direct and important pecuniary stake in their enterprises than can be the case with the chief executives of our large railroad corporations, the ownership of which is scattered in the hands of several hundred thousand shareholders.

Industries Here and Abroad Also Deal with Particular Bankers

Yet, there are hardly any industrial concerns either here or in Europe which dispose of their securities by competitive bidding among bankers or by direct offering to the public. Practically all such corporations pursue the course of negotiating with one particular banker or group of bankers and entrusting the handling of their security issues to such banker or group of bankers so long as their services prove satisfactory. Their action is conclusive evidence that the system of competitive bidding is found unsuitable and disserviceable by the consensus of opinion of those in charge of industrial affairs, here and in Europe.

II

How Railroad Securities Are Placed With the Public

The great complexity involved in the sale of securities will readily be seen from a brief outline of the method usually adopted in marketing a large issue of bonds. The railroad, in the first instance, sells the issue to a strong banking firm at a price mutually agreed upon through negotiation. That firm then associates with itself a syndicate consisting of many (usually hundreds) of other banking, brokerage, investment and distributing houses throughout the country, each having its clientele of investment customers.

Bankers Buy Securities for Distribution to Investors

Bankers, of course, do not buy securities for permanent investment by themselves. If bankers or syndicates permanently kept the securities which they bought from the railroads their capacity to undertake such transactions would be exhausted very soon.

If securities are to be placed, they must ultimately find lodgment with investors, and, while the amounts of securities taken by large investors, such as the life insurance companies, savings banks and capitalists, appear large, their aggregate, especially since the advent of the high surtaxes, is small compared with the investments of the rank and file of small investors.

Pending the formation of a syndicate, the firm which has contracted with the railroad stands in the breach, and is responsible to the railroad whether or not it succeeds in forming the syndicate. Even after the formation of the syndicate, the practice is that the responsi-

bility of the contracting firm continues and it remains liable to the railroad for the due fulfillment by each syndicate member of the obligation undertaken by him.

Securities Not Taken by Investors Must Be Carried by Syndicates

Then begins the laborious process of selling securities to ultimate investors, through advertising, letters and circulars and personal presentation, and in this labor are engaged large numbers of dealers in securities, each with his own clientele. In time, if the issue is a success, the securities are absorbed.

If the issue is not a success the participants in the syndicate must either sell the securities at a loss or carry them along until the advent of propitious times enables them to dispose of them.

Surtaxes Have Practically Eliminated Investment In Railroad Securities By Those With Large Incomes

The selling of securities to the public has in recent years undergone a radical change. Formerly, the principal buyers of railroad bonds were wealthy individuals and large corporations, especially insurance companies and savings banks. The former, owing to the surtaxes, have practically been eliminated as absorbers of railroad bonds and confine their investments very largely to tax-exempt securities, while the insurance corporations and savings banks do not invest as largely as before the war in railroad securities.

It has therefore been found necessary to discover new channels for the absorption of railroad bonds. This has been accomplished within the past few years by a most intensive campaign of education and distribution among the rank and file of investors.

Vast Army of Small Investors Has Been Developed by Bankers

The result has been exceedingly gratifying in that a vast army of small investors has been developed. The achievement is of great public consequence from the social and economic point of view.

III

The Proposal to Market Railroad Securities by Competitive Bidding

It is now urged in certain quarters that railroad companies would do better if they should discontinue dealing habitually with particular banking houses, and, whenever they have securities to sell, would offer them for sale by competitive bidding among bankers, regardless of past affiliations.

Some even go so far as to advocate that bankers, as such, should not be used at all, not even upon a competitive basis, but that the railroad companies should sell their securities directly to their own stockholders or to the public at large, preferably offering them for public tender and accepting the proposals of the highest bidders.

New Proposal Involves Uncertainty

If railroads offered bonds direct for public subscription in limited amounts, the result might be fairly satisfactory in good or normal times, although even then, deprived of the facilities, the skill and the sponsorship of responsible bankers, the prices obtained would probably be lower than those which would have been realized by dealing with a banker, and that consideration takes no account of the uncertainty in which the railroad would necessarily find itself as to what portion of the funds it required would be in fact realized as the result of the public offering.

Moreover the public demand would naturally concentrate itself upon the issues of the best known and

most prosperous railroads, making it very difficult for railroads not enjoying high credit to obtain necessary funds,—all the more difficult, as the system of competitive bidding would offer no inducement to bankers to take upon themselves the risk and responsibility of acquiring such issues.

The Danger of a Less Consistent Financial Policy

Under that plan there would likewise be less assurance of the pursuance by railroads of a sound and consistent financial policy such as a prudent and conservative banker requires as a basis for commending securities to the confidence of the investing public which looks to the banker for advice and leadership.

In unfavorable times, of course, the public's response to an offering of securities is small, at times exceedingly small. It occurs frequently that bankers or syndicates have to carry issues of bonds, which they have purchased, for many months or even years, until investment demand revives. If an issue of bonds offered by a railroad for competitive bids on direct public subscription resulted in non-success, the issue, if saleable at all, could only be disposed of at a very heavy sacrifice.

Failure to Dispose of Issue Would Impair Railroad Credit

The failure of a public offering and the consequent public knowledge that the railroad had been unable to obtain the funds it requires, would cause grave damage to a railroad's credit, if it did not for the time entirely destroy it, would cause alarm amongst investors, and in not a few cases might cause bankruptcy.

That is the vital and fundamental difference between the risk incurred by municipalities and that incurred by railroads in the disposal of their bonds by public bidding. If a municipality fails to dispose of its bonds, the situation thereby created, though embarrassing, does not ordinarily involve grave harm, and can be dealt with.

If a railroad fails, however, the damage done is exceedingly grave at best—and may be irremediable.

The "Public" Does Not Bid

As a matter of fact, unrestricted public competition does not in practice mean what the term implies, because all experience has shown that the public does not care for such bidding and actually refrains from participating therein to any appreciable extent. Even in the case of municipal securities, it is amply demonstrated that the offerings are not taken by the public in the process of competitive bidding, except in a very limited measure. The successful bidders both as to quantity and price are almost invariably bankers or banking syndicates, who buy for resale to the investor.

Public Relies on Bankers' Advice

The public wisely requires, even in the case of municipal securities, the advice and moral responsibility of bankers. They want to be sure that all legal matters have been properly looked into by somebody, not the seller, and that the soundness and validity of the security is vouched for by a competent and reliable firm.

If, as experience has shown, the public cannot be depended on to cover the offering even of municipal bonds by competitive bidding, this would be so in a still more pronounced degree in the case of railroad securities. It follows that public competition would really mean not offering securities to the public, but offering them to the bankers.

The banker, if he were—as he would be in this case—entirely free to bid or not bid, to pick and choose, to take the best and leave the less good alone, would actually leave the less good alone, with the result that many railroads would find themselves faced with the grave consequences of the failure of public offerings.

Municipal and State securities possess the immense advantage of being tax free. Yet it has happened, in the past quite often, and even not unfrequently of more recent dates, that such issues were not covered when offered for public bidding, the failure, entire or partial, being due usually to their being unsuited to the market or because of some doubt as to their legality. Can it be doubted that the same result would occur much more frequently in the case of railroad securities if offered for public bidding?

The Experience of Cities

It is true that government and municipal securities in this country are usually offered for competitive bidding, but government, state and municipal financing is not comparable with corporation financing. In the former case the securities based upon the taxing authority are in the simplest form—generally little more than a plain promise to pay—and in recent years, since the advent of high surtaxes, a ready market is usually assured by the tax exemption feature.

Public Officials Consult Bankers As to Issuing Large Loans

Nevertheless public officials usually deem it wise to consult bankers before determining their financial policies and particularly before issuing large loans, and at times have sought and obtained in advance informal guarantees from bankers that offerings will be covered. They can of course rely upon bankers rendering assistance as a matter of civic duty. In the case of railroads, with the element of habitual clientage between railroad and banker eliminated, it would naturally be impossible to count upon any such uncompensated advice and assistance.

Even Municipal Offerings Fail At Times

As illustrating the point that the financing of state and even the highest grade municipal bonds has not always been successful in spite of the tax exemption feature, it may be mentioned that in June and August, 1907, the City of New York offered two issues of bonds of $29,000,000 and $15,000,000, respectively, for which bids of only $2,100,000 and $2,700,000, respectively, were received. The issues were sold by private sale to bankers a few months later.

About the same time a small offering of bonds by the State of New York met with a similar result.

In 1914, shortly after the outbreak of the war, the City of New York, finding itself in immediate need of $100,000,000 of gold to pay notes maturing in England and France, turned to J. P. Morgan & Company and Kuhn, Loeb & Company, who, without compensation, as a matter of public duty, undertook to organize, and in the midst of conditions of unprecedented difficulty, did organize a syndicate to provide the necessary funds.

N. Y. City Issues Often Require Bankers' Support

In more than one instance in the years preceding that occurrence, the City was compelled, in order to avoid failure of an issue offered for public tender for the purpose of meeting pressing requirements, to have recourse to one or the other of the leading banking houses. In numerous cases, it was only large subscriptions by such banking houses—made often without any expectation of profit and resulting none too rarely in losses—which avoided the, at least partial, failure of public offerings of the bonds of the City of New York.

There is no reason to believe that the cities have been better off under the practice of selling bonds at public offering to the highest bidders than they would have

been had they been permitted to deal privately with the bankers as do the railroads. But, even if it were otherwise, it is manifest that railroad companies could not possibly expect to fare as well as do the municipalities if they had to depend upon the uncertain and fluctuating public demand when they attempt to sell their securities at public offering to the highest bidder.

Competitive Bidding Would Bring Uncertainty In Railroad Financing

Especially does this hold true in the case of the less strong railroads, where a careful analysis and study of the condition of the company and sometimes even an auditor's or an expert's report is required before a conservative banker will stand sponsor for the company's securities. The investing public will neither take the trouble, nor does it possess the qualifications, to analyze for itself the position of the securities of the less well-known properties and to form a reasoned estimate as to their degree of safety, based, as such estimate must be, upon the compilation and study of statistical and other data, which it is among the functions of the banker to gather and to make available to his investment clients in convenient and easily understood form.

United States Farm Loan Bureau Relies On Bankers' Services

In this connection it is significant that the Farm Loan Bureau of the United States Treasury has found it advantageous to issue the bonds of the Farm Loan banks not by competitive bidding but through a group of bankers selected by the Bureau whom it may at all times feel free to consult and who watch the markets in the interest of the Bureau.

European Practice

In not a single European country does the system prevail of competitive sale, either general or limited, of securities on the part of corporations. Moreover, many

even of the Governments and Municipalities in placing their loans, have recourse not to competitive bidding but to regularly established and continuous connections with a banking house or a group of banking houses. Not one of the foreign Governments, belligerent or neutral, which during the European war have found access to the American investment market for the securities of their respective countries, had recourse to competitive bidding amongst bankers or otherwise. In each instance the Government concerned has dealt with some one particular banker or group of bankers whom it selected as efficient and worthy of confidence.

Dealing With Selected Bankers Still Continues Abroad

A cabled inquiry addressed within a week to eight different countries in Europe, and also to Japan, to find out whether, since the war, the practice has been modified in those countries of dealing with selected bankers for the sale of public service and other corporate securities and even, in numerous cases, governmental or municipal bonds, elicits the information that no reason has been found to change that practice and that it continues to prevail.

IV

The Present Method of Underwriting the Sale of Stocks to Shareholders

Under the laws of most states and the charters of most corporations, it is necessary that new issues of stock, or of bonds carrying the privilege of conversion into stock, must first be offered for *pro rata* subscription to the corporations' stockholders. In such cases the banker's knowledge of markets is valuable to advise the corporation of the character of securities which its shareholders are likely to accept or for which the subscription rights would command a market value.

New Stock Offering Creates Technically Weak Market Position

When an offering of new stock is made to shareholders of a corporation it creates a technically weak market position, inasmuch as both the existing stockholder and the speculator know that there is a mass of new stock about to issue, and the market must absorb it. Consequently the speculator is apt to incline towards rushing into the market, arguing to himself: "I will sell that stock. I will get it back cheaper. The market must absorb such and such a number of millions of new stock, and it cannot do that without going down. I am quite safe in selling some."

Experience has shown that in many cases the stockholder to whom the so-called right to subscribe for new stock is offered, does not exercise that right. He is not always prepared to put up additional cash. He frequently sells his "rights" for whatever may be their market value.

Consequently, by the very issue of additional stock, offered to existing stockholders, there is created an unfavorable and somewhat hazardous market condition. Naturally, the tendency invariably is for the offering of stock to depress the existing level of the stock. That may go so far as to remove any inducements to the stockholder to subscribe for the new stock, and to render "rights" valueless. An unprotected offering, i. e., an offering not protected by underwriters, is a target for selling.

Moreover, not to mention the damage to its credit in case of the failure of such an offering, the railroad is uncertain pending the time in which the securities are under offer to the stockholders (usually not less than from 45 to 60 days) whether or not, or to what extent, the stockholders will subscribe, and is, consequently, in doubt whether, at the end of the subscription period, it will come into possession of the funds it requires.

Underwriting Guarantees Success and Protects Security Values

All of this is obviated by the formation of an underwriting syndicate inasmuch as it guarantees to take and pay for any part of the offering which the stockholders may not want to take. The existence of such a syndicate and the resulting guarantee of the success of the offering has a strong moral effect upon the stockholders in encouraging them to subscribe, and an equally strong effect in discouraging speculators from "short selling" while an unprotected offering invites such selling.

It follows that a railroad can safely afford to offer securities at a much higher price when underwritten than they would risk fixing when not secured and protected by an underwriting.

A characteristic illustration of the foregoing is furnished by the experience of the Pennsylvania Railroad

Company, than which there is no stronger railroad corporation in the country, when in 1903, it, *without underwriting,* offered $75,000,000 of its stock for subscription by its stockholders at 120%. The market price of the stock at the time was, and for some time had been, around 145%. Owing to the large difference between the market price and the price of the offering, the officers and directors of the railroad deemed it unnecessary to insure success by an underwriting.

The Hazard Exemplified in a Pennsylvania Railroad Experience

As a result of changes in market conditions, sales of rights by stockholders and selling by speculators, it being known that there was no underwriting syndicate, the market value of the stock rapidly declined. When the price in its descent had reached 125½ and the failure of the offering appeared imminent, the railroad finally called upon its bankers to form a syndicate to underwrite the issue, which was promptly done. The reassuring effect of the mere public announcement that a syndicate had guaranteed to take and pay for any part of the offering which was not subscribed for by the stockholders, was such as to arrest immediately the selling on the part of alarmed stockholders as well as by speculators. The decline in the market stopped, and a threatened failure, which might have involved serious consequences and affected railroad credit generally, was turned into a complete success.

The Plan of Underwriting Usually Assures Better Terms and Higher Prices

Even after taking into consideration the expense of an underwriting syndicate, a railroad will usually obtain materially higher net proceeds from an underwritten offering, than from one not underwritten, in addition to the advantage of being certain of securing the required funds.

Manifestly, it is more advantageous to a railroad's financial position and the maintenance of the price level of its securities to offer a security, even to its stockholders, at say 110, and pay a reasonable underwriting commission, rather than to offer it at par without an underwriting.

The cases in which railroad companies or other corporations have successfully sold their securities direct to the investor are exceedingly rare, and even then usually at prices below what could have been obtained from bankers.

Actual Experience With Direct Offerings

To quote only one example of non-success in the case of direct dealing with the public, the Vermont Valley Railroad in 1914 offered for competition by sealed tenders an issue of $2,300,000 of its 6% one-year notes. Although the Vermont Valley Railroad was a very prosperous concern, having a record at that time of having paid dividends at the rate of 10% per annum for nine years, and the notes had the additional security of being guaranteed by the Connecticut River R. R. Co., the offering resulted in complete failure, practically no bids having been received.

On the other hand, the case of the American Telephone and Telegraph Company which recently sold a large issue of stock at par directly to its stockholders, without the intermediation of bankers, has been cited as significant and indicative of the possibilities of effective results without the co-operation of bankers. The real significance in that case, however, lies in the patent fact that had that issue been underwritten by bankers a considerably higher price for the company could have been obtained. The security sold by the American Telegraph and Telephone Company was seasoned stock pay-

ing 9% dividends. It was offered at par. Bankers, in consideration of a reasonable commission, would gladly have underwritten the offering at a considerably higher price. It should be understood that this does not imply any suggestion of criticism as to the course pursued by the Company. There were valid considerations of broad policy which guided the decision of those in responsible charge, to give to the vast body of its stockholders the benefit of a stock offering at a particularly attractive price.

V

Effective Competition Prevails Under Present Methods

There are ever present elements of actual or potential competition which assure favorable terms to a railroad company dealing habitually with the same bankers.

The price and the margin of profit or commission at which a banker concludes a negotiation with a railroad company for its securities is necessarily in competition with the terms upon which other bankers negotiate with other railroad companies for their securities.

The prices at which railroads sell their securities are now matters of public record. Moreover, the terms of a contract between the railroad and the banker are subject to the approval of the Interstate Commerce Commission. No banker expecting to maintain his regular connection with a railroad company can do otherwise than pay full and fair value for the securities which it has to sell. It is a matter of necessity and self-interest for him to do so.

The Pressure of Stockholders Upon Directors for Best Results Is Important

Railroad companies, through various means, are well able to place an accurate estimate upon the market value of securities which they have for sale, and no board of directors could afford to incur the opprobrium and responsibility of selling securities to their regular banking connections otherwise than on the basis of what they are reasonably and fairly worth, considering the time and the conditions.

The prevailing market prices of existing issues fix very closely the prices at which new securities can be sold to investors. The banker who would make a practice

of marketing the securities of his clients at prices materially below the prevailing prices, for issues of similar character and quality would soon lose his clients.

Importance of Regarding Results In the Long Run

In isolated instances, for the purpose of obtaining advertisement or position, or even, in certain instances, for reasons of a less legitimate kind, others than the regular banking connections of particular railroads may conceivably be willing to pay a somewhat higher price for an issue of securities than such regular connections; but there is no reason whatever to think that such "occasional" bidders would be able or willing to do better for the railroads, year in and year out, than the bankers usually acting for those railroads. On the contrary, there is every reason to expect the reverse.

Whether through a system either of unrestricted public bidding or of competitive bidding limited to bankers, the railroads year in and year out would obtain higher prices for their securities than have been and are being realized under the existing time-tested system, is a matter of opinion and cannot be anything else. Whether that opinion is pro or con, there can be no question that as against gaining a wholly problematical and uncertain benefit the railroads stand to lose the certain, well-established and weighty advantages which now accrue to them through the responsibility and moral and practical obligations toward them of the bankers with whom they habitually deal.

What Is Required of A Banker

To market railroad securities on a large scale requires a combination of skill, experience, capital, reputation and connections that, from the nature of the case, can be possessed by only a limited number of concerns at any

one time, because only the test of time will produce most of these necessary qualities.

Ability To Market Securities

That skill, experience and reputation it is the business of the banker to make available to his clients, together with his financial potency and relationships.

A banker of long experience with a record of success, conservatism and integrity, develops a power to place securities that is of great value to his clients, cumulatively so the longer the relationship is maintained.

Results Must be Judged Over Period Covering Both Rising and Declining Markets

The question of the best and most serviceable method of selling railroad securities must be determined not from the wholly exceptional and fortuitous circumstances which have prevailed during the last year, but in the light of the experience of the longer past and the needs of the future.

In the marketing of securities, as in other businesses, there are occasional periods of excessive activity, usually of comparatively short duration, occasional periods of acute depression and longer periods of normal activity.

Past Year No Criterion of Normal Marketing Conditions

It happens that this year has been a period of unparalleled activity in the marketing of securities of domestic issues, simultaneously with, and partly caused by, growing reluctance to invest in issues of European countries. There has been a vast and almost insatiable demand for new domestic securities, particularly bonds, an almost uninterrupted decrease in interest rates and a corresponding increase in the market value of securities.

The result has been that bankers and syndicates have been much more than usually successful in marketing the domestic security issues which they have purchased and that as a rule new security issues have advanced in the market and reached prices in excess of the issue price. The upward trend of security values is illustrated by the fact that in the last ten months the average market price of ten standard railroad bond issues taken at random has increased about thirteen points.

It has been a time when it was possible to indulge in improvident bidding or "spite-bidding," without being deterred by the swift penalty of non-success in marketing, which follows such practices under normal circumstances.

Recent Period No Safe Guide for General Procedure

Under these conditions, it is easy for critics who consider only recent experience, and whose knowledge does not carry them back to the pre-war years (which, after all, furnish the best standards for judging the future), to jump at the conclusion that the railroads have not been receiving the best possible prices for the securities they have marketed and that higher prices would have been realized if the sale of railroad securities had been opened up for competition.

Criticism has been especially easy and abundant on the part of those who have little or no background of experience in the marketing of railroad securities to guide them, who have not had to bear the responsibility of financing the requirements of great railroad properties in normal times and during periods of depression and who do not realize the necessity of looking ahead to the future periods of depression or of more normal demand for securities when the railroads of the country will have the same need for new capital as now.

VI

Present Procedure Has Proved of Advantage to the Railroads

To deal through bankers in accordance with present practice, has actually proved itself a source of distinct financial advantage to railroads—even the most prosperous and soundly financed companies.

A few conspicuous cases may be cited here to illustrate the point:*

How An Underwriting Syndicate Averted Failure of $100,000,000 Bond Issue

1. In March, 1905, the Pennsylvania Railroad arranged with its bankers to form a syndicate to underwrite the offer to its shareholders at par of $100,000,000 Pennsylvania Railroad 3½ per cent Convertible Bonds (convertible into stock at 150 per cent). The stockholders subscribed for less than 10 per cent of the offering and, consequently, the underwriting syndicate had to take and pay for about $90,000,000 of the bonds. The bonds within the year declined to 97½ per cent and never again reached par, the price at which they were first offered.

If it had not been for the underwriting syndicate, the situation, resulting from the failure of the stockholders to subscribe and thus provide the money needed by the railroad, would have been very embarrassing to the railroad and very serious in its effect upon the general financial and investment situation of the country.

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* A number of additional instances of a similar value to the railroads will be found on pages 33 to 37.

2. In 1908, a situation had arisen which had brought the market for railroad bonds in this country to a complete standstill. Railroads for many months were unable to obtain funds, except, to a limited extent, by means of the costly and dangerous expedient of selling short term notes. The effect was cumulative and far-reaching and threatened to bring about serious consequences. At this juncture the bankers of the Pennsylvania Railroad succeeded in inducing the two foremost banking houses in England, Messrs. N. M. Rothschild & Sons, and Messrs. Baring Brothers & Co., Ltd. (the former of whom had not issued an American security for many years), to purchase and bring out jointly with them at 96 per cent an issue of $40,000,000 Pennsylvania Railroad 4 per cent Consolidated Bonds.

Largely in consequence of the prestige and placing power and investment following of the issuing houses, the public offering was a complete success and its effect, as recognized by many published comments here and abroad, was to break the deadlock which had existed, and to cause capital to flow again freely into the investment market.

Pennsylvania Bond Flotation In 1908 Broke Investment Deadlock

3. In August, 1913, bankers formed a syndicate to underwrite the offer to Union Pacific stockholders of $88,000,000 Southern Pacific Stock Trust Certificates at 92 per cent. The effectuation of that sale was of very great importance as, failing it by a certain very near date, the Southern Pacific stock in question would have been placed, under a court decree, in the hands of a receiver, the sentimental and actual effect of which course would have been grave.

In the face of many predictions that a syndicate to guarantee the sale of so vast an amount of stock could

not be formed under the then prevailing generally disturbed and unfavorable conditions, the bankers, with the aid of their connections throughout America and Europe, succeeded in the undertaking, the syndicate as finally made up consisting of nearly a thousand participants. It is entirely safe and well within bounds to say that if that mass of stock had been offered without guarantee and protection of an underwriting syndicate, it would not have been sold—if at all, within the time limit set by the court—at a price averaging better than *80 per cent.*

United States Attorney-General Required Underwriting U. P.-S. P. Dissolution Sale

4. In connection with the first plan for the dissolution of the Union Pacific-Southern Pacific combination approved by Attorney-General Wickersham (which failed of adoption because of the refusal of the California Railroad Commission to approve certain of its features), he *imposed* the condition that the sale of the Union Pacific Company's holdings of Southern Pacific stock (which would be offered for *pro rata* purchase to the stockholders in the Southern Pacific Company) should be underwritten by a syndicate.

He imposed that condition for the manifest reason that the sale of the stock, however attractive the price to the stockholders might be, could be insured only in case definite arrangements were made for a sale of the stock that might not be taken by the stockholders upon the offering.

None of the aforementioned transactions, under the circumstances of the cases and the times, could have been effected equally well, if at all, by any method of competitive negotiating or bidding.

VII

The Payment to the Banker is for Assuming a Substantial Risk and Performing a Valuable Service

The risk taken by the banker and the syndicates he may organize is always a real and at times a very great one. There is widespread misapprehension as to the profits made by bankers and syndicates upon the underwriting and purchase of securities of railroad companies.

Bankers' Remuneration for Risk and Services Involved

There is also a frequently encountered misconception to the effect that the railroads are in the habit of paying a commission to the banker when selling securities to him.

When the banker forms a syndicate to underwrite an offer of securities to shareholders a fixed commission is naturally stipulated, commensurate with the advantage secured by the railroad company in obtaining through the underwriting the certainty of the success of its offering, and with the risk incurred by the banker and the syndicate affiliated with him.

Bankers Usually Buy Securities From A Railroad At A Fixed Price

On the other hand, in the case of the sale of railroad securities to or through bankers without an offering to stockholders, it is very unusual for the sale to be on a commission basis. As a rule, the procedure is that the banker makes a firm bid to the railroad for such securities at a fixed price, said price with the addition of a reasonable standardized percentage for his own compensation being the figure at which he expects to be able to form a syndicate. That compensation is in return for his preparatory work, his moral and actual responsi-

bility and risk and his services in managing the syndicate. It is a charge made by the banker *to the syndicate.*

Bankers' Charge A Fixed Percentage

The compensation of the banker and the anticipated profit of the syndicate are practically a fixed percentage. The banker's method is not, to buy low and sell high. In fixing the selling price to the public, he merely adds to the purchase price a certain percentage to cover his own and his syndicate's compensation and expenses, and that percentage does not vary materially irrespective of whether the purchase price was say 90% or 95% or 100%.

His aim and inducement are to buy at a price which will enable the securities to be sold to the public after adding to that price the customary compensation. He has no inducement whatever to buy at a lesser price, because *his compensation would not be increased thereby,* but on the other hand the good will and approval of the railroad concerned would be jeopardized.

Risk Does Not End With the Formation of A Syndicate

When a syndicate is formed the banker's financial risk is by no means ended, as, in practically all cases, he is himself a large participant in the syndicate—is, in fact, expected to be. Moreover, generally, he remains financially responsible to the railroad for the commitment of each individual syndicate participant. The railroad looks to him for the due performance of the contract, and not to the hundreds of syndicate members.

The Bankers' Responsibility To the Syndicate

Again, his moral risk and responsibility towards the syndicate is great, inasmuch as he is relied upon by its members to have examined carefully into the soundness of the security, to have scrutinized the mortgage, to have taken competent legal advice, to have correctly gauged the moment and estimated the price at which the securities can be advantageously placed with the

public, to do the principal work in marketing them, and to guide the work done by others.

The Penalty of Failure on the Banker's Part

If the banker is found wanting in any of these respects, or his judgment proves to be faulty, he loses the confidence of those who habitually participate in syndicates, and with it, his capacity to engage in financial transactions on a large scale, as it is only with the cooperation, financial or otherwise, of syndicates that large transactions can be carried through.

The spread on which the syndicate figures as between the purchase price and the price of resale to the public is not more than sufficient to cover the expense of "overhead," the outlay for advertising, circularizing and counsel fees, and reasonable compensation divided over hundreds of syndicate participants and distributing houses for their risk and their work in placing the securities with the public. In view of the change which has taken place, as previously referred to, in the clientele for railroad bonds (owing to the preference of large investors for tax-exempt bonds) the selling of railroad securities has become both a more laborious and intensive and a more costly process than formerly. In addition to a highly trained and expensive office staff, bondhouses nowadays must employ an army of travelling salesmen.

Extensive Distributing Service Must Be Employed

In order to get issues of railroad securities well placed among, and absorbed by, bona fide investors, it is necessary, under the conditions created by the advent of high surtaxes, to employ retail distributing houses throughout the country to a far greater extent than used to be the case. The margin upon which the calculations of the syndicate and its managers are based, must therefore

be sufficient to enable reasonable compensation to be afforded to such retail distributing houses so as to give them a fairly adequate inducement to put forth their efforts in placing the securities.

If, through an excessive narrowing of the margin, whether due to vagaries of competitive bidding or to other causes, such adequate inducement cannot be given to that nation-wide force of distributing houses in the case of railroad securities, the inevitable result would be that these houses would more and more relinquish that field and devote their principal attention to pushing the distribution of industrial and other securities, of which a constantly growing supply is available.

Banker's Profit Limited, But His Loss Indeterminate

Under the methods now prevailing, it is wholly impossible that the originating banker, the syndicate participants and the distributing houses can make an undue profit as between the railroads and the public. The expected compensation for their respective services is expressed in practically standardized percentages, varying somewhat in accordance with the quality of the security and the risk and difficulty of the business. There *can be no profit* to bankers, syndicates or distributors over and above these percentages, but of course there *can be a loss* if the banker's judgment as to the price which a given security is worth or as to the general condition of the investment market is at fault, or if a sudden change occurs in that market owing to unforeseen events. The limit of possible profit is fixed, the limit of possible loss is indeterminate.

Service of European Bankers Less Comprehensive Than American

It is worth mentioning in this connection that the banker in England does not render the same measure of service to the corporations whose securities he sells to

the public, as does the American banker. It is the practice of the London banker, immediately after the public issue has taken place, to dissolve his syndicate, distribute amongst the syndicate participants any bonds remaining unsold and leave it to them to sell at the best price they can get. He does not usually consider himself responsible to endeavor to protect the stability of the issue price.

American Practice More Serviceable and Involves Greater Responsibility

The practice of the American banker, on the contrary, in cases where a public issue has not resulted in placing with the public the entire amount offered, is to keep his syndicate together for a certain length of time (sometimes for a great length of time), to retain charge of the disposal of the unsold balance and to continue his efforts to place the same with the investing public at the original issue price—a practice fairer and more serviceable both to the railroads and to the public. Even in the case of wholly successful issues, it is the usual practice here to keep the syndicate together for from two to three months, so as to be ready to "protect" the market, as more fully explained later.

Some Instances of Syndicate Risks Turned Into Losses

The following actual cases which are by no means exhaustive, indicate the risks incurred by banking syndicates, and illustrate the losses and vicissitude to which they are subject:

Erie

1. In September, 1905, The Erie Railroad arranged with its bankers to form a syndicate to underwrite the offer to its shareholders at 100% of $12,000,000 Convertible 4% Bonds, Series "B" (convertible into common stock at $60 per share). The

result of the offering was that the stockholders subscribed for only 18 per cent and, consequently, the syndicate had to take and pay for $9,840,000 of the bonds. The syndicate was dissolved in December, 1906, none of the bonds taken by it having been disposed of. The bonds were listed on the Stock Exchange in February, 1907, when they sold at 85%.

M. K. & T.

2. In January, 1906, The Missouri, Kansas & Texas Railway arranged with its bankers to form a syndicate to underwrite the offer to its shareholders at 87½% of $10,000,000 General Mortgage 4½% Bonds. The stockholders subscribed for only 50 per cent of the offering and the syndicate had to take $5,000,000 of the bonds. The syndicate was dissolved in December, 1907, only a few of the bonds taken by it having been disposed of.

Union Pacific

3. In May, 1907, the Union Pacific arranged with its bankers to form a syndicate to underwrite the offer to its stockholders at 90% of $75,000,000 4% Convertible Bonds (convertible into stock at 175%). The stockholders subscribed for barely 5 per cent of the offering and, consequently, the syndicate had to take and pay for about $70,000,000 of the bonds. The bonds in the course of the following six months declined to 78¼%.

B. & O.

4. In January, 1913, the Baltimore & Ohio Railroad Company arranged with its bankers to form a syndicate to underwrite the offer to its stockholders at 95½% of $63,000,000 4½% Convertible Bonds (convertible at 110%). The stockholders subscribed for barely 30 per cent of the offering and, consequently, the syndicate had to take and pay for about $44,000,000 of the bonds. In the course of a few months the bonds declined to 88½%.

Wisconsin Central

5. In April, 1906, the Wisconsin Central Railway arranged with bankers to form a syndicate to underwrite the offer to its shareholders at 89% and

interest, of $7,000,000 Superior & Duluth Division & Terminal First Mortgage 4% Bonds. The stockholders subscribed for only 1 per cent of the offering and the syndicate had to take $6,930,000 of the bonds. The syndicate expired by limitation July 1, 1908, none of the bonds taken by it having been disposed of in the interval.

Sante Fe

6. In March, 1910, The Atchison, Topeka & Santa Fe Railway Company arranged with its bankers to form a syndicate to underwrite the offer to its shareholders at 102½% of $43,686,000 Convertible 4% Bonds due 1960. The stockholders subscribed for only about 12½ per cent of the offering, leaving about $38,000,000 of the bonds to be taken by the syndicate.

Southern

7. In February, 1906, the Southern Railway sold to its bankers $20,000,000 Development and General Mortgage 4% Bonds at 89% less commission. The syndicate formed by the bankers to handle this transaction remained in existence for nearly 2½ years, i. e., till July 1, 1908, at which time the syndicate members had to take up 68 per cent of their participations. The market price of the bonds at that date was 74%.

Western Maryland

8. In January, 1909, the Western Maryland Railroad sold to bankers $6,500,000 First Mortgage 4% Bonds. On January 18, 1909, about 90 per cent of the bonds had to be taken up by syndicate participants. No bonds were disposed of by the syndicate until September, 1910, and from then on, at various dates up to February 28, 1911; thus the syndicate lasted more than two years.

Seaboard Airline

9. In June, 1909, the Seaboard Air Line arranged with bankers for the formation of a syndicate to guarantee the sale of $18,000,000 Adjustment Bonds at 70%. November 1, 1909, syndicate members took up about 90 per cent of the bonds, which were dis-

posed of in small lots between February, 1910, and November 30, 1910, the syndicate thus lasting about one and one-half years.

Chicago City and Connecting Railway

10. In January, 1910, bankers purchased $22,000,000 Chicago City & Connecting Railways Collateral Trust 5% Bonds, and formed a syndicate at 91%. The syndicate expired in February, 1912, leaving syndicate members with almost 90 per cent of the total amount unsold in their hands.

Examples From War and Post-War Periods

It will be observed that all the above examples, the list of which could be considerably prolonged, relate to the period preceding the war. The selection has been so made purposely, because ever since the beginning of the war the conditions of the investment market have not been normal. During the greater part of that period they were abnormally adverse, while since the beginning of the present year they have been abnormally favorable. Therefore, the war and post-war periods offer no basis upon which to found permanent conclusions. However, a few examples from these periods, which might be greatly multiplied, may be inserted here:

C. & O.

11. In March, 1916, bankers formed a syndicate to underwrite the offer to stockholders of $40,180,000 Chesapeake & Ohio Railway Co. 30 year 5% Secured Convertible Gold Bonds at 97½% and accrued interest. The stockholders subscribed for but slightly over 5 per cent of the offering and the syndicate had to take and pay for $38,047,500 of the bonds, equal to 94¾ per cent of the issue. At the time when the syndicate was called upon to make good its obligation, the bonds were selling in market at 94⅞%.

C. M. & St. P.

12. In January, 1917, the Chicago, Milwaukee and St. Paul Railway sold to its bankers at 93½% $25,-

000,000 General and Refunding Mortgage 4½% Bonds, Series "A", due January 2014. On April 24, the syndicate was dissolved, the members having to take up 43 per cent of their participations. The bonds at that time were selling in the market at 88½%.

B. & O.

13. In June, 1919, the Baltimore & Ohio Railroad Company sold to its bankers at 93½% $35,000,000 of Ten-Year 6% Secured Gold Bonds. The syndicate remained in force until January 30, 1920, when the members had to take up 23 per cent of their participations. The bonds were then selling in the market at 83⅝%.

C. C. C. & St. L.

14. In July, 1919, the Cleveland, Cincinnati, Chicago & St. Louis R. R. Co. sold to its bankers at 95½% $15,000,000 6% Bonds. On December 1, 1919, the syndicate was dissolved, the members having to take up 11 per cent of their participations. The bonds were then selling in the market at about 86%.

VIII

The Nature and Value of an Established Banking Relationship

The considerations which make a system under which railroads would offer their securities direct for public bidding, precarious, hazardous and futile are so patent and so conclusive, that it may well be assumed that no reasonably informed person will contend seriously that it would be either advantageous or safe for railroad companies to pursue the course of attempting to market their securities without the trained cooperation of bankers.

The question remains to be discussed whether *it is in the public interest* that a railroad company should habitually deal with a particular banker and give that banker the preference when it has securities to be sold or underwritten as long as—and only so long as—it is satisfied with his services. The following considerations are offered in support of this, the existing practice:

1. The present plan enables a railroad to be certain of its ability to secure the necessary funds for its commitments.

Certainty of Securing Funds Maintains Railroad Credit

It is of the greatest importance for a railroad, when making commitments for expenditures for improvements, new construction, equipment, etc., to be certain that it will be able to sell the requisite securities when such commitments come due and must be met. That is a fundamental principle of sound railroad financing.

In dealing regularly with a banking house of ample financial strength and wide connections, the railroad company is assured that it will be able to obtain the requisite funds, even in unfavorable times, because the

banking house, in order to insure the continuity of the connection and the solvency of the railroad, cannot do otherwise than use to the utmost the resources and the facilities of connections and credits at its disposal, to provide for the requirements of the railroad.

Temporary Accommodations Often Required By Railroads

If, on the other hand, the railroad had been in the habit of selling its securities on a competitive basis, it would have no such friend in need, and the various bond and banking houses would naturally buy its securities only as it suited their own purposes. The strongest railroads have found themselves in the situation where large sums of money have been imperatively needed in most unfavorable times and where only their claims upon their regular bankers have enabled them to obtain the necessary funds.

It has of late years been a matter of not infrequent occurrence that during the pendency of applications for the approval by a public service commission of proposed bond issues, railroads have found themselves in need of temporary financial accommodation. For such accommodation, if not readily or opportunely obtainable from the railroad's banks and trust company connections, the railroad would turn to its banker.

Furthermore, in the case of bonds, the application for the issue of which is pending before a public service commission, it is not unusual for the banker, at the railroad's request, to obligate himself to purchase such bonds, subject to the approval of their issue by such commission, so that the railroad is protected against an unfavorable change in the investment markets while its application is being considered and is certain of obtaining the needed funds as soon as the application is granted.

The temporary financial accommodation previously referred to, and the definite sale of bonds in advance of, and subject to action by public service commissions, have at times been of great service and value to railroads. It is doubtful whether either expedient would be at the service of a railroad if securities were sold by competitive bidding among bankers.

There have also been numerous instances when railroads which found themselves confronted with grave financial problems or in need of large sums for refunding purposes have applied to bankers to evolve plans and inaugurate measures for dealing with these problems comprehensively, for strengthening their credit, or for their financial rehabilitation without the expense and detriment of a receivership. The accomplishment of this task on the part of the banker involves much time, thought and study as well as a degree of financial risk and the assumption of great moral responsibility toward investors who, following the banker's advice, may aid in furnishing the requisite funds and who look to the banker to safeguard such investments.

Assistance of Banking House May Mean Avoidance of Bankruptcy

Last April, for example, the New York, New Haven & Hartford Railroad Company was faced with the maturity of $28,000,000 of debentures of which one-half were held in France and one-half in this country. The company's credit was not sufficient to make a new issue of securities possible. Failure to meet or extend the debentures at maturity would have meant bankruptcy.

With the active aid of banking houses through whom the debentures had been placed originally and with whom the company had been in consultation many months in advance, a voluntary extension of the deben-

tures was secured. The negotiations involved a great deal of time, thought, skill and effort, and, it is fair to say, could not have been successfully concluded, except through the influence, prestige, skill and activity of the banking houses concerned.

It is a significant fact that most of the railroads which have gone into receivers' hands in recent years had followed the practice of selling their securities to different bankers at different times, and for the financing and support of, and advice to, such railroads, and the preservation of their solvency, accordingly, no single banking house felt itself responsible.*

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2. A railroad's financial requirements must be foreseen and assured long in advance of the actual need, and the present practice makes that possible.

Preparation Required for $200,000,000 N. P.-G. N. Refunding

In July, 1921, when investment conditions had not yet become propitious an issue of the combined bonds of the Northern Pacific and Great Northern Companies aggregating $200,000,000 fell due. The refunding of this vast amount of bonds was successfully accomplished with the aid of the bankers who had been concerned in their issue originally. The preparations for this refunding operation had been in progress for the best part of a year and were necessarily of the most elaborate character.

Manifestly, this immense operation could have been successfully carried through on an acceptable basis only by experienced bankers of high standing and nation-wide connections, who were familiar with the history of

*(Examples: Wabash, Western Maryland, Wheeling & Lake Erie, Kansas City, Mexico & Orient, St. Louis & San Francisco, Norfolk & Southern, Chicago Great Western, Chicago Rock Island & Pacific, etc.)

the transaction and the manner in which the securities to be refunded were held, and who had adequate inducement to give to this complex and difficult negotiation the time and thought and the painstaking effort which its preparation required.

Cases of Security Sales Requiring Protracted and Complex Negotiations

In June, 1906, when the investment market in this country was practically at a standstill, American bankers placed an issue of Francs 250,000,000 Pennsylvania Company 3¾% Bonds in France; in February, 1907, an issue of Francs 145,000,000 New York, New Haven & Hartford Railroad Company 4% Bonds in France and Germany; in March, 1910, an issue of Francs 150,000,000 Chicago, Milwaukee & St. Paul 4% Bonds in France and England; and in February, 1911, an issue of Francs 250,000,000 Central Pacific Railway Company 4% Bonds in France and England.

All of these loans were negotiated at times when it was of great advantage to the railroads as well as to the general financial situation to obtain money abroad. They took many weeks of preliminary negotiation and complex arrangements and *could not possibly have been negotiated on a competitive basis.*

One railroad company alone must provide for $130,000,000 of maturities in 1925—and another for $50,000,000 the same year. It will inevitably be necessary for these companies to consult with bankers a long time before the maturity date, and devise plans for refunding, and obtain competent advice as to the best moment and method for carrying out these large transactions.

No banker could reasonably be expected to undertake the task and assume the responsibility of building up a railroad's credit, of studying and advising upon financial policies and methods, and putting his skill and placing power and sponsorship at its disposal if he had

to expect that after having devoted his time, effort and reputation to the work, the security-issues of the railroad would be thrown open to competitive bidding, whether general or confined to bankers, regardless of whether or not his own services were faithful and efficient and satisfactory to the board of directors and management.

Competitive Bidding Would Deprive Railroad of Financial Advice of Banking Houses

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3. The technical advice and the assistance growing out of the practical experience of the banker are of great value to the railroad.

A. Importance of Advice as to the Best Time to Issue Securities

In dealing regularly with one banking house, a railroad obtains the benefit of expert advice (and that from some one thoroughly familiar with, and interested in, its affairs) as to financial policy, as to the best and most opportune time for selling securities, and for providing for its financial requirements, as to the class and kind of securities best suited to conditions prevailing and to be anticipated, and as to the best method of offering them to the public.

Time Element Important to Railroads

The element of the selection of time is of much importance in itself, for it happens not infrequently that the lapse of a single week or less measures the difference between reasonably favorable and unfavorable or even totally forbidding conditions.

The ebb and flow of the currents in the investment markets depend on many and complex conditions and considerations, and it is one of the functions of the competent banker to keep himself posted as to affairs, aspects and prospects in America, Europe, and elsewhere,

and to anticipate in his judgment and advice their results and their effects upon the money and investment markets.

Advice and Cooperation In Declining Markets

The advice and co-operation of the banker are especially important to railroad eompanies during periods of declining security values, with which the Interstate Commerce Commission has not yet had occasion to deal, inasmuch as during the more recent past there has been an almost continuous upward trend of priees. In times of declining markets for securities, quick action and sound advice are particularly essential. Premature publication of a company's intention to issue new securities must be guarded against. Apart from other considerations, holders of its securities already outstanding might hasten to sell their holdings without waiting for full information. Such premature selling might so affect the market as to make the new transaction more costly or perhaps impossible.

Furthermore, publie knowledge that one or more issues of railroad sccurities are contemplated, might cause industrial concerns or foreign governments or municipalities to hasten offerings of their own securities, as indeed has occurred in the past, so as to anticipate the railroads' offerings and get prior access to the investment market. The supply of available investment capital has, of course, its limitations, and in normal times the rule "first come, first served" does apply to a certain degree.

Prospective Bidders Would Benefit By Decline

If a sale by publie tender or by competitive negotiating or bidding among bankers were required, no one would be interested in supporting the market for a company's outstanding securities; in fact, prospective bidders would be benefited by a declinc. On the other

hand, with bankers having a continued interest in its welfare and a publicly recognized moral responsibility for its securities, the situation is quite different.

In this connection the question may be pertinent as to the relative desirability of the practice of selling securities before (or simultaneously with) the application to the Interstate Commerce Commission for approval, the transaction being made subject to the Commission's subsequent approval, or of delaying the offering until the Commission's approval has actually been obtained. On the whole, the first method, although not free from objection, would seem to be the safer and more desirable from the point of view of the railroads. It is quite impossible for any banker to definitely advise a corporation, with any degree of positiveness, as to the price its securities will command several weeks later. Too many elements of uncertainty are involved. The publication, weeks in advance of the actual consummation of the transaction, of the intention of railroad companies to make issues of securities might prove seriously detrimental as indicated in the preceding paragraph.

Importance of Allowing Exercise of Maximum Discretion By the Companies

Everything considered, it would seem best that the companies should be accorded discretion to exercise their own best judgment in each instance whether they should sell subject to subsequent approval by the Commission, or should first obtain the Commission's leave for selling, at a price not below a stated minimum.

B. Importance of Advice as to Technical Details Surrounding Issuance of Securities

It is of great importance that care should be taken that new issues of bonds should comply with the statu-

tory requirements of various states respecting legal investments of insurance companies, savings banks and other fiduciary institutions. Whether or not a given issue of bonds meets these requirements will often make a difference of several points in their value.

Investors Look To Bankers to Safeguard Securities Technically

Investors attach considerable importance to knowing that the mortgages, trust deeds, etc., and all legal steps relating to the issue of securities which they are asked to buy have been carefully examined by bankers of repute and experience and their counsel, with a view to safeguarding the interest of the holders of the bonds as distinguished from those of the railroads, the makers of the bonds.

The mortgages and trust deeds under which the securities are to be issued, before being put in final shape, are carefully gone over by the banker, and his advice is given with the view to creating the best and most saleable instrument satisfactory both to the public and to the railroad company, and having due regard both for the protection of the investor and for the future financial requirements of the railroad. Such advice is frequently, especially in the case of large refunding mortgages which are meant to be the principal means of raising money for the railroads for years to come, of very great utility. It is likewise greatly valued by the investor who has come to rely upon the tried and tested thoroughness and competence of experienced and highly reputed bankers to protect the interests of the investing public in respect of not only the intrinsic goodness of a security for which they become sponsors, but also in respect of the provision of the mortgage or trust deed appertaining to such security.

4. The bankers' dual obligation to the investing public on the one hand and on the other to the corporations whom he serves, constitutes a protection to both.

The leading bankers could not maintain their position as such, if they did not have the confidence of the investing public and a large following amongst investors, large and small, both here and abroad.

Careful analysis, continuous and watchful scrutiny, in respect of securities issued by him and of the companies concerned, are essential functions of the banker. In buying securities and offering them for sale, he gives public notice, so to speak, that he has examined into, and satisfied himself as to, their safety and merit.

Investors Rely on Integrity and Judgment of Bankers

The banker does not safeguard merely the technical and, to the best of his ability, the intrinsic soundness of the securities he issues; it is alike his duty and to his own self-interest to protect and stand behind the securities for which he is recognized as sponsor, just as it is his duty and to his own self-interest to satisfy himself by careful investigation as to the soundness of such securities, because the banker whose clients suffer loss through following his advice will very soon lose his reputation and the confidence and patronage of his clients.

The banker knows well that such reputation and confidence are the mainstays of the prosperity and success of his own business and, once forfeited, are exceedingly difficult to regain.

"Protecting" the Market

The function of the banker in "protecting" the market for securities issued through his house is of peculiar importance.

Important That Small Investors Be Protected

Reference has been made to the altered character of the investment market, in which a great army of small investors has come into existence to take the place of the larger investors who because of preference for tax-exempt securities, can no longer be counted upon to be a considerable factor in absorbing railroad securities.

If that army, so important and desirable from the social and economic viewpoint, and created at such great cost and effort, is not to disintegrate again, it is absolutely indispensable that the market for the securities which they have bought, be "protected" at least for a reasonable length of time after the offering (barring exceptional economic or financial changes)—which protection is one of the useful and legitimate functions of leading issuing houses and has no relationship whatever to what is usually termed manipulating or "rigging" the market.

It must be made somebody's business to see to it that if the investor wishes to sell within a reasonable time after having bought, he can, under normal conditions, find a market at or near the price at which he bought.

Ready Market Must Be Secured For Re-Sales

To provide such a market by being able and willing to a reasonable extent to repurchase bonds sold by him, is part of the business of the banker who made the public offering—*provided that he has a definite and acknowledged relationship toward the company whose bonds he has offered.* If he has no such relationship, if the public offering is simply the result of competitive bidding, either general or limited, the banker may be expected to be apt to feel that his functions are completed when he has marketed the securities.

The result would be that the immensely valuable work which had been done lately of popularizing railroad bonds might be largely undone, the vast clientele which had been created for railroad bonds might be materially curtailed, and the resulting diminished demand for railroad bonds could not fail to be reflected in the price level which they would command.

Value of Banker's Continuing Responsibility

The *continuing responsibility* of the banker for bonds which he has offered and sold under the existing system of dealing between bankers and railroads is an exceedingly valuable element from the point of view of the small investor and a strongly steadying factor in the market for railroad securities. That responsibility would be jeopardized by competitive bidding, whether general or limited.

It is interesting to note in this connection that even so eminently successful a public offering as that of the recently issued United States Government 4¼% Bonds, was followed by a substantial decline in the market price of those bonds below the price of issue. There being no one responsible for the "protection" of the market for those bonds, the price declined quickly from the issuing price of 100 to 98.90%, which in the case of the world's premier government security has considerably greater significance than a like decline would have in the case of a corporate issue.

Important To Avoid Disappointing Investors

It is to the interest of a railroad company that its securities should be absorbed by the investing public and that their *market value should be maintained,* under normal conditions. It is more important to the railroad industry at large that a favorable reputation, the good-

will of the investing public and a broad, steady demand for its securities should be preserved than that in every instance the very top notch price should be obtained to which, through taking advantage of fortuitous circumstances, the purchasing banker may be driven. To disappoint and disgruntle the investor by selling him securities at unduly high prices which will not stand the test of the workings of ordinary supply and demand, is, in its ultimate consequences, to be "penny wise and pound foolish," especially since railroad securities are more and more coming into competition for public favor with industrial securities.

Issues Sponsored By Well Known Bankers Have Wider and Steadier Market

The end the railroad company should always have in mind is to maintain a broad and stable market for its securities, and to that end, wise discretion in the interest of railroad credit generally and of the particular borrower, may even make it desirable, in given instances, under all the surrounding circumstances of the case, to accept an offer which would enable re-sale to the public under tested and responsible auspices at a fair and reasonable price, rather than an offer of an extreme price with the resulting consequence of the re-sale to the public being attempted necessarily at an unduly high level.

It may safely be said that such railroad issues as are known to be under the habitual sponsorship and consequent moral responsibility of well-known and strong bankers have a wider and steadier market and command better prices amongst investors than those which are not under such auspices and responsibility.

If the sale of securities were thrown open to competitive negotiating or bidding, either general or limited, the possession of large capital would tend to become

the prime requisite for dealing in securities, and the financier or combination of financiers controlling the largest amount of capital would have a much more potent advantage over others than under now existing conditions.

The exercise of care, skill, industry, scrutiny and the sense of moral responsibility toward clients, which now are and always have been the prerequisite for acquiring the reputation and the public confidence upon which an Investment Banker's position depends and without which it cannot be maintained for any length of time, would no longer be essential.

IX

Summary and Conclusion

A. The vital necessity is to obtain for the railroads the assurance of adequate capital upon favorable terms.

B. The existing practice of selecting, and dealing with, a particular banking house as long as its services give satisfaction, is an outgrowth of actual experience in the effective marketing of securities.

C. In dealing with so delicate a matter as security markets it is of primary consequence that any plan adopted for the sale of securities shall command the utmost confidence on the part of investors.

D. The existing practice has proven itself, in numerous instances, of the greatest utility to railroad corporations, and actual experience demonstrates that the remuneration to bankers and syndicates is but a fair equivalent for very real services actually performed and risks assumed, and that the average of such remuneration, over a term of years, has afforded no more than a reasonable return upon the capital involved, and due compensation for the work rendered.

E. The existing practice has been found effective by industrial corporations not subject to public regulation, and it is the method employed by many foreign governments and municipalities in the issuing of securities.

F. Some of the advantageous characteristics of the present practice are:

1. The relationship between railroad and banker is wholly informal and continues only as long as it

is deemed advantageous to the railroad by its officers and directors.

2. The relationship, while in no way limiting the railroad's freedom of action, does impose upon the banker definite and continuous duties and obligations.

3. The bankers have no power to determine the decision of railroads in such matters.

4. The banker is not only the distributor of, and propagandist for railroad securities, but he fulfills, at his own risk and cost, the important and valuable function of steadying and protecting the market for such securities.

5. The railroad receives continuously the knowledge, services, skill, standing, financial advice, and financial potency of the banker in both good and evil times.

6. The banker advises as to the financial situation and policy of the railroad, prepares plans for meeting requirements, recommends the kind and character of the security to be created, scrutinizes mortgages and trust deeds, and indicates the best moment at which to sell.

7. The bonds of the corporation represent a promise to pay. The value of that promise depends not merely upon the tangible security offered, but also upon excellence and fidelity of management. While strictly refraining from any attempt to influence the operating and tariff policies of the railroad, it is the banker's duty and self-interest, to the best of his ability, to promote wise and sound management and safe financial policies on the part of the corporation, the securities of which he has issued and for which he has consequently assumed moral sponsorship before the investing public.

8. Even where affiliations between particular bankers and railroads avoid nominal competition,

there is a potential competition which operates powerfully in the following particulars:

a. The fact that complete publicity is by law enforced as to the terms upon which security issues are obtained by bankers naturally causes both the banker and the railroad to seek to give, on the one hand, and to obtain on the other, the best terms which conditions and circumstances warrant.

b. The fact that the terms involved in a contract between the railroad and the banker must be approved by public authority is a moral guarantee that such terms will be proposed as will stand well-informed scrutiny.

c. If railroads find that other companies are securing better terms through other bankers, it is inevitable that other bankers will ultimately obtain the business.

d. If railroads cannot obtain what they consider satisfactory terms from their regular bankers, they are entirely free to terminate the negotiations and do business with others.

G. There is no reason to think that, year in and year out, railroads would obtain higher prices for their securities under any form of competitive negotiating or bidding than under the present practice. There is every reason to think that the stability and broad receptiveness of the market for railroad securities would be lessened and the interests of the investors less carefully and responsibly safeguarded.

H. Many, if not all of the effective values of the advantages (both to the railroads and to the investing public) inherent in the present practice, would be elimi-

nated by competitive negotiating or bidding, whether unrestricted or confined to bankers. No banker could be expected to give his time, effort, reputation and responsibility, material and moral, to the financial affairs of a corporation if he is wholly uncertain whether he will reap any return for his services, as must necessarily be the case in the event of competitive negotiating or bidding.

I. To change the prevailing practice would mean to give up definite and tested benefits, alike to the railroads and to the public, for the sake of one wholly problematical advantage.

J. Practical experience shows that the operation of the present method under public supervision and with full publicity attending it, *assures more success than any other plan yet proposed or practiced in obtaining the necessary capital for the railroads upon favorable terms.*

K. To the extent that the terms upon which securities are sold have a bearing upon the rates paid by the public for railroad service, the present method secures to the public, insofar as that item is concerned, the lowest burden upon the rates and the greatest assurance of the railroads being able to obtain the capital to provide necessary facilities.

CONCLUSION

To compel railroads to have recourse for the sale of their securities to competitive negotiating with or bidding on the part of bankers and brokers, or to direct offerings to the public, would be to run counter to the practice and experience of every country in the world.

It would confuse and trouble the investing public and destroy elements and features of evident and proved value for public protection.

It would tend to make the possession of capital the sole requisite for dealing in securities, irrespective of skill, care, reputation and the confidence of investors.

It would limit, hamper and restrain the flow of capital into American railroad securities and cause delay, uncertainty, risk and damage to railroad corporations.

Railroads and other corporations should be left free, under the responsibility of their board of directors, and subject to such authority over the issue of their securities as is now exercised by the Interstate Commerce Commission, to deal with whatever banking houses they deem it in their best interest to employ.

They should neither be bound by contract or control to deal with any one banking house exclusively, nor forced by statute or regulation to take the chances involved in competitive negotiating or bidding among bankers or of direct dealing with the public.

Respectfully submitted,

KUHN, LOEB & CO.

October 25, 1922.